ARIZONA CORPORATION COMMISSION
UTILITIES DIVISION

ANNUAL REPORT MAILING LABEL – MAKE CHANGES AS NECESSARY

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G-04204A
UNS Gas, Inc.
Attn: David Couture
PO Box 711, MS UE201
Tucson, AZ 85702

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AZ CORPORATION COMMISSION
DIRECTOR OF UTILITIES

ANNUAL REPORT

FOR YEAR ENDING

12	31	2007

FOR COMMISSION USE

ANN 02	07

PROCESSED BY: 4-16-08

SCANNED

COMPANY INFORMATION

Company Name (Business Name) UNS Gas, Inc.

Mailing Address PO Box 711, Mail Stop UE201
(Street)

Tucson	AZ	85702
(City)	(State)	(Zip)

520-884-3752	520-884-3601	N/A
Telephone No. (Include Area Code)	Fax No. (Include Area Code)	Cell No. (Include Area Code)

Email Address dcouture@tep.com

Local Office Mailing Address PO Box 711, Mail Stop UE201
(Street)

Tucson	AZ	85702
(City)	(State)	(Zip)

520-884-3752	520-884-3601	N/A
Local Office Telephone No. (Include Area Code)	Fax No. (Include Area Code)	Cell No. (Include Area Code)

Email Address dcouture@tep.com

MANAGEMENT INFORMATION

Management Contact: David Couture (Name) — Director of Regulatory Services (Title)

One South Church Avenue, Mail Stop UE201	Tucson	AZ	85702
(Street)	(City)	(State)	(Zip)

520-884-3752	520-884-3601	N/A
Telephone No. (Include Area Code)	Fax No. (Include Area Code)	Cell No. (Include Area Code)

Email Address dcouture@tep.com

On Site Manager: Gary Smith (Name) — Vice President and General Manager

2901 W. Shamrell Blvd., Suite 110	Flagstaff	AZ	86001
(Street)	(City)	(State)	(Zip)

928-226-2233	928-226-2203	N/A
Telephone No. (Include Area Code)	Fax No. (Include Area Code)	Cell No. (Include Area Code)

Email Address gasmith@uesaz.com

☒ **Please mark this box if the above address(es) have changed or are updated since the last filing.**

Statutory Agent: Diana Durako
(Name)

One S. Church Avenue, UE201	Tucson	AZ	85701
(Street)	(City)	(State)	(Zip)

520-571-4000 ext. 3652	520-884-3601	N/A
Telephone No. (Include Area Code)	Fax No. (Include Area Code	Cell No. (Include Area Code)

Attorney: Raymond S. Heyman
(Name)

P.O. Box 711	Tucson	AZ	85702
(Street)	(City)	(State)	(Zip)

520-571-4000	520-884-3612	N/A
Telephone No. (Include Area Code)	Fax No. (Include Area Code)	Cell No. (Include Area Code)

☒ **Please mark this box if the above address(es) have changed or are updated since the last filing.**

OWNERSHIP INFORMATION

Check the following box that applies to your company:

- ☐ **Sole Proprietor (S)**
- ☒ **C Corporation (C) (Other than Association/Co-op)**
- ☐ **Partnership (P)**
- ☐ **Subchapter S Corporation (Z)**
- ☐ **Bankruptcy (B)**
- ☐ **Association/Co-op (A)**
- ☐ **Receivership (R)**
- ☐ **Limited Liability Company**
- ☐ **Other (Describe)**__________

COUNTIES SERVED

Check the box below for the county/ies in which you are certificated to provide service:

☒ **APACHE**	☐ **COCHISE**	☒ **COCONINO**
☐ **GILA**	☐ **GRAHAM**	☐ **GREENLEE**
☐ **LA PAZ**	☐ **MARICOPA**	☒ **MOHAVE**
☒ **NAVAJO**	☐ **PIMA**	☐ **PINAL**
☒ **SANTA CRUZ**	☒ **YAVAPAI**	☐ **YUMA**
☐ **STATEWIDE**		

SERVICES AUTHORIZED TO PROVIDE

Check the following box/es for the services that you are authorized to provide:

- ☐ **Electric**
  - ☐ Investor Owned Electric
  - ☐ Rural Electric Cooperative
  - ☐ Utility Distribution Company
  - ☐ Electric Service Provider
    - ☐ Transmission Service Provider
    - ☐ Meter Service Provider
    - ☐ Meter Reading Service Provider
    - ☐ Billing and Collection
    - ☐ Ancillary Services
    - ☐ Generation Provider
    - ☐ Aggregator/Broker
- ☐ **Telecommunications**
  - ☐ Incumbent Local Exchange Carrier
  - ☐ Interexchange Carrier
  - ☐ Competitive Local Exchange Carrier
  - ☐ Reseller
  - ☐ Alternative Operator Service Provider
- ☒ **Gas**
  - ☒ Natural Gas
  - ☐ Propane
- ☐ **Other** (Specify)______________________________

____

STATISTICAL INFORMATION

TELECOMMUNICATION UTILITIES ONLY

Total residential access lines	____________
Total business access lines	____________
Total revenue from Arizona operations	$____________
Total income from Arizona operations	$____________
Value of assets used to serve Arizona customers	$____________
Accumulated depreciation associated with those assets	$____________

STATISTICAL INFORMATION (CONT'D)

ELECTRIC UTILITY PROVIDERS ONLY

Total number of customers	
Residential	
Commercial	
Industrial	
Public street and highway lighting	
Irrigation	
Resale	
Total kilowatt-hours sold	kWh
Residential	
Commercial	
Industrial	
Public street and highway lighting	
Irrigation	
Resale	
Maximum Peak Load	MW

GAS UTILITIES ONLY

Total number of customers (at 12-31-07)	145,962
Residential	133,256
Commercial	11,577
Industrial	23
Irrigation	5
Public Authority	1,076
Transportation Service with Negotiated Sales Program Contract (1)	14
Transportation Service without Negotiated Sales Program Contract (2)	9
Electric Generation (3)	2
Total therms sold	281,530,787 therms
Residential	71,766,226
Commercial	30,987,173
Industrial	1,950,539
Irrigation	93,385
Public Authority	6,860,246
Transportation Service with Negotiated Sales Program Contract (1)	19,093,737
Transportation Service without Negotiated Sales Program Contract (2)	5,622,662
Electric Generation (3)	145,156,819

(1) Under the Company's Negotiated Sales Program tariff, it may compete for the gas commodity business of its transportation customers. This line includes those transportation customers for which we also provide their gas commodity.
(2) Transportation Service customers are billed a usage rate that does not include the cost of gas. Quantity indicated represents customer procured gas delivered through UNS Gas, Inc. facilities.
(3) UNS Gas transports gas to two electrical generating facilities. The quantity indicated represents the total volume of gas delivered to these customers over UNS Gas facilities irrespective of whether such gas was procured by the customer or UNS Gas.

VERIFICATION
AND
SWORN STATEMENT
Intrastate Revenues Only

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AZ CORPORATION COMMISSION
DIRECTOR OF UTILITIES

VERIFICATION

STATE OF Arizona	COUNTY OF (COUNTY NAME) **Pima**
I, THE UNDERSIGNED	NAME (OWNER OR OFFICIAL) TITLE **Karen G. Kissinger, VP - Controller & CCO**
OF THE	COMPANY NAME **UNS Gas, Inc.**

DO SAY THAT THIS ANNUAL UTILITY REPORT TO THE ARIZONA CORPORATION COMMISSION

	MONTH	DAY	YEAR
FOR THE YEAR ENDING	12	31	2007

HAS BEEN PREPARED UNDER MY DIRECTION, FROM THE ORIGINAL BOOKS, PAPERS AND RECORDS OF SAID UTILITY; THAT I HAVE CAREFULLY EXAMINED THE SAME, AND DECLARE THE SAME TO BE A COMPLETE AND CORRECT STATEMENT OF BUSINESS AND AFFAIRS OF SAID UTILITY FOR THE PERIOD COVERED BY THIS REPORT IN RESPECT TO EACH AND EVERY MATTER AND THING SET FORTH, TO THE BEST OF MY KNOWLEDGE, INFORMATION AND BELIEF.

SWORN STATEMENT

IN ACCORDANCE WITH THE REQUIREMENT OF TITLE 40, ARTICLE 8, SECTION 40-401, ARIZONA REVISED STATUTES, IT IS HEREIN REPORTED THAT THE GROSS OPERATING REVENUE OF SAID UTILITY DERIVED FROM ARIZONA INTRASTATE UTILITY OPERATIONS DURING CALENDAR YEAR 2007 WAS:

Arizona Intrastate Gross Operating Revenues Only ($)

$ 164,577,167

(THE AMOUNT IN BOX ABOVE INCLUDES $13,597,628 IN SALES AND FRANCHISE TAXES BILLED, OR COLLECTED)

****REVENUE REPORTED ON THIS PAGE MUST INCLUDE SALES TAXES BILLED OR COLLECTED. IF FOR ANY OTHER REASON, THE REVENUE REPORTED ABOVE DOES NOT AGREE WITH TOTAL OPERATING REVENUES ELSEWHERE REPORTED, ATTACH THOSE STATEMENTS THAT RECONCILE THE DIFFERENCE. (EXPLAIN IN DETAIL)**

Karen G. Kissinger
SIGNATURE OF OWNER OR OFFICIAL

520-745-3122
TELEPHONE NUMBER

SUBSCRIBED AND SWORN TO BEFORE ME

A NOTARY PUBLIC IN AND FOR THE COUNTY OF COUNTY NAME Pima

THIS 14th **DAY OF** MONTH April 2008

(SEAL)

Cheryl T. Gottshall
SIGNATURE OF NOTARY PUBLIC

MY COMMISSION EXPIRES 06/30/2010

Notary Public State of Arizona
Pima County
Cheryl T Gottshall
My Commission Expires
06/30/2010

VERIFICATION
AND
SWORN STATEMENT
RESIDENTIAL REVENUE
INTRASTATE REVENUES ONLY

RECEIVED

APR 15 2008

AZ CORPORATION COMMISSION
DIRECTOR OF UTILITIES

STATE OF ARIZONA	COUNTY OF (COUNTY NAME) **Pima**	
I, THE UNDERSIGNED	NAME (OWNER OR OFFICIAL) **Karen G. Kissinger**	TITLE **VP – Controller & CCO**
OF THE	COMPANY NAME **UNS Gas, Inc.**	

DO SAY THAT THIS ANNUAL UTILITY REPORT TO THE ARIZONA CORPORATION COMMISSION

FOR THE YEAR ENDING	**MONTH**	**DAY**	**YEAR**
	12	31	2007

HAS BEEN PREPARED UNDER MY DIRECTION, FROM THE ORIGINAL BOOKS, PAPERS AND RECORDS OF SAID UTILITY; THAT I HAVE CAREFULLY EXAMINED THE SAME, AND DECLARE THE SAME TO BE A COMPLETE AND CORRECT STATEMENT OF BUSINESS AND AFFAIRS OF SAID UTILITY FOR THE PERIOD COVERED BY THIS REPORT IN RESPECT TO EACH AND EVERY MATTER AND THING SET FORTH, TO THE BEST OF MY KNOWLEDGE, INFORMATION AND BELIEF.

SWORN STATEMENT

IN ACCORDANCE WITH THE REQUIREMENTS OF TITLE 40, ARTICLE 8, SECTION 40-401.01, ARIZONA REVISED STATUTES, IT IS HEREIN REPORTED THAT THE GROSS OPERATING REVENUE OF SAID UTILITY DERIVED FROM ARIZONA INTRASTATE UTILITY OPERATIONS RECEIVED FROM RESIDENTIAL CUSTOMERS DURING CALENDAR YEAR 2007 WAS:

ARIZONA INTRASTATE GROSS OPERATING REVENUES
$ 100,198,366

(THE AMOUNT IN BOX AT LEFT INCLUDES $ 8,718,072 IN SALES AND FRANCHISE TAXES BILLED, OR COLLECTED)

***RESIDENTIAL REVENUE REPORTED ON THIS PAGE MUST INCLUDE SALES TAXES BILLED.**

X Karen G. Kissinger
SIGNATURE OF OWNER OR OFFICIAL

520-745-3122
TELEPHONE NUMBER

Notary Public State of Arizona
Pima County
Cheryl T Gottshall
My Commission Expires
06/30/2010

SUBSCRIBED AND SWORN TO BEFORE ME

A NOTARY PUBLIC IN AND FOR THE COUNTY OF

THIS 14th **DAY OF**

NOTARY PUBLIC NAME	Cheryl T. Gottshall	
COUNTY NAME	Pima	
MONTH	April	,2008

(SEAL)

MY COMMISSION EXPIRES 06/30/2010

X Cheryl T. Gottshall
SIGNATURE OF NOTARY PUBLIC

FINANCIAL INFORMATION

Attach to this annual report a copy of the companies' year-end (Calendar Year 2007) financial statements. If you do not compile these reports, the Utilities Division will supply you with blank financial statements for completion and filing. **ALL INFORMATION MUST BE ARIZONA-SPECIFIC AND REFLECT OPERATING RESULTS IN ARIZONA.**

UNS Gas, Inc.

Financial Statements

Years Ended December 31, 2007 and 2006

UniSourceEnergy
SERVICES

PRICEWATERHOUSECOOPERS

PricewaterhouseCoopers LLP
One North Wacker
Chicago, IL 60606
Telephone (312) 298 2000
Facsimile (312) 298 2001
www.pwc.com

Report of Independent Auditors

To the Board of Directors and Stockholder of
UNS Gas, Inc.

In our opinion, the accompanying balance sheets and statements of capitalization and the related statements of income, cash flows, and changes in stockholder's equity and comprehensive income present fairly, in all material respects, the financial position of UNS Gas, Inc. (the "Company) at December 31, 2007 and December 31, 2006 and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits of these statements in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

PricewaterhouseCoopers LLP

PricewaterhouseCoopers LLP
Chicago, Illinois
April 10, 2008

UNS GAS, INC.
STATEMENTS OF INCOME

		Years Ended December 31, 2007		2006
		- Thousands of Dollars -		
Operating Revenues				
Gas Revenue	$	148,657	$	159,655
Other Revenues		2,296		2,362
Total Operating Revenues		150,953		162,017
Operating Expenses				
Purchased Gas		101,529		114,427
Other Operations and Maintenance		26,849		24,598
Depreciation and Amortization		7,649		6,732
Taxes Other than Income Taxes		2,982		2,918
Total Operating Expenses		139,009		148,675
Operating Income		11,944		13,342
Other Income (Deductions)				
Interest Income		1,142		796
Other		392		(120)
Total Other Income		1,534		676
Interest Expense				
Long-Term Debt		6,422		6,445
Allowance for Funds Used During Construction		(254)		(110)
Other		637		379
Total Interest Expense		6,805		6,714
Income Before Income Taxes		6,673		7,304
Income Taxes		2,679		2,916
Net Income	$	3,994	$	4,388

See Notes to Financial Statements.

UNS GAS, INC.
STATEMENTS OF CASH FLOWS

	Years Ended December 31, 2007	2006
	- Thousands of Dollars -	
Cash Flows from Operating Activities		
Cash Receipts from Gas Sales	**$ 165,677**	$ 173,243
Interest Received	**856**	407
Other Cash Receipts	**1,390**	159
Purchased Gas Costs Paid	**(97,137)**	(97,504)
Taxes Paid, Net of Amounts Capitalized	**(17,115)**	(17,322)
Payment of Other Operations and Maintenance Costs	**(11,201)**	(10,779)
Wages Paid, Net of Amounts Capitalized	**(7,187)**	(6,847)
Interest Paid, Net of Amounts Capitalized	**(6,122)**	(6,240)
Income Taxes Paid	**(43)**	(2,750)
Other Cash Payments	**(750)**	(861)
Net Cash Flows - Operating Activities	**28,368**	31,506
Cash Flows from Investing Activities		
Capital Expenditures	**(22,589)**	(23,404)
Proceeds from Sale of Land and Buildings	**506**	428
Net Cash Flows - Investing Activities	**(22,083)**	(22,976)
Cash Flows from Financing Activities		
Proceeds from Borrowings under Revolving Credit Facility	**-**	5,000
Repayment of Borrowings under Revolving Credit Facility	**-**	(5,000)
Customer Advance Receipts	**3,397**	5,044
Customer Advance Refunds	**(2,519)**	(3,201)
Payment of Debt Issuance Costs	**(7)**	(81)
Intercompany Repayments	**(6,544)**	(5,652)
Net Cash Flows - Financing Activities	**(5,673)**	(3,890)
Net Increase in Cash and Cash Equivalents	**612**	4,640
Cash and Cash Equivalents, Beginning of Period	**18,693**	14,053
Cash and Cash Equivalents, End of Period	**$ 19,305**	$ 18,693

See Notes to Financial Statements.

UNS GAS, INC.
BALANCE SHEETS

	December 31, 2007	December 31, 2006
	- Thousands of Dollars -	
ASSETS		
Utility Plant		
Plant in Service	$ **217,212**	$ 204,151
Construction Work in Progress	**9,618**	7,199
Total Utility Plant	**226,830**	211,350
Less Accumulated Depreciation and Amortization	**(4,878)**	(16,219)
Total Utility Plant - Net	**221,952**	195,131
Current Assets		
Cash and Cash Equivalents	**19,305**	18,693
Trade and Other Accounts Receivable	**11,774**	17,359
Unbilled Accounts Receivable	**18,015**	14,655
Allowance for Doubtful Accounts	**(1,011)**	(367)
Receivable from Related Parties	**28**	885
Materials and Supplies	**2,022**	2,161
Income Tax Receivable	**448**	-
Deferred Income Taxes	**546**	284
Energy Contracts - Derivative Assets	**14**	-
Other	**118**	539
Total Current Assets	**51,259**	54,209
Other Assets		
Regulatory Assets	**1,494**	1,845
Unamortized Debt Discount and Expense	**817**	993
Energy Contracts - Derivative Assets	**68**	-
Other	**-**	715
Total Other Assets	**2,379**	3,553
Total Assets	$ **275,590**	$ 252,893

See Notes to Financial Statements.

UNS GAS, INC.
BALANCE SHEETS

		December 31, 2007		December 31, 2006
		- Thousands of Dollars -		
CAPITALIZATION AND OTHER LIABILITIES				
Capitalization				
Common Stock Equity	$	**88,265**	$	84,154
Long-Term Debt		**100,000**		100,000
Total Capitalization		**188,265**		184,154
Current Liabilities				
Over Recovered Purchased Gas Costs Regulatory Liability		**13,084**		10,707
Accounts Payable		**20,664**		19,800
Payable to Related Parties		**2,150**		1,282
Taxes Accrued		**4,703**		4,873
Customer Deposits		**3,090**		3,364
Interest Accrued		**2,462**		2,454
Income Taxes Payable		**-**		4
Accrued Employee Expenses		**979**		878
Other Regulatory Liabilities		**27**		-
Other		**129**		152
Total Current Liabilities		**47,288**		43,514
Deferred Credits and Other Liabilities				
Net Cost of Removal for Interim Retirements Regulatory Liability		**17,318**		3,999
Deferred Income Taxes		**10,451**		8,320
Customer Advances for Construction		**10,397**		10,392
Deferred Employee Benefits		**1,787**		2,438
Other		**84**		76
Total Deferred Credits and Other Liabilities		**40,037**		25,225
Total Capitalization and Liabilities	$	**275,590**	$	252,893

See Notes to Financial Statements.

UNS GAS, INC.
STATEMENTS OF CAPITALIZATION

			December 31, 2007	2006
			- Thousands of Dollars -	
COMMON STOCK EQUITY				
Common Stock--No Par Value			$ **67,978**	$ 67,978
	2007	**2006**		
Shares Authorized	**1,000**	1,000		
Shares Outstanding	**1,000**	1,000		
Accumulated Earnings			**20,208**	16,214
Accumulated Other Comprehensive Income (Loss)			**79**	(38)
Total Common Stock Equity			**88,265**	84,154
LONG-TERM DEBT				
Issue	**Maturity**	**Interest Rate**		
Senior Unsecured Notes - Note A	8/11/2011	6.23%	**50,000**	50,000
Senior Unsecured Notes - Note B	8/11/2015	6.23%	**50,000**	50,000
Total Stated Principal Amount			**100,000**	100,000
Less Current Maturities			**-**	-
Total Long-Term Debt			**100,000**	100,000
Total Capitalization			$ **188,265**	$ 184,154

See Notes to Financial Statements.

UNS GAS, INC.
STATEMENTS OF CHANGES IN STOCKHOLDER'S EQUITY AND COMPREHENSIVE INCOME

	Common Shares Outstanding	Common Stock	Accumulated Earnings	Accumulated Other Comprehensive Income (Loss)	Total Stockholder's Equity
			- Thousands of Dollars -		
Balances at December 31, 2005	**1,000**	**$ 67,978**	**$ 11,826**	**-**	**$ 79,804**
Comprehensive Income:					
2006 Net Income	-	-	4,388	-	4,388
Total Comprehensive Income					4,388
Adjustment to Initially Recognize the Funded Status of Employee Benefit Plans (net of $25 income taxes)	-	-	-	(38)	(38)
Balances at December 31, 2006	**1,000**	**$ 67,978**	**$ 16,214**	**$ (38)**	**$ 84,154**
Comprehensive Income:					
2007 Net Income	-	-	3,994	-	3,994
Decrease in Post-Retirement Medical Liability (net of $45 income taxes)	-	-	-	68	68
Unrealized Gain on Cash Flow Hedges (net of $32 income taxes)	-	-	-	49	49
Total Comprehensive Income					4,111
Balances at December 31, 2007	**1,000**	**$ 67,978**	**$ 20,208**	**$ 79**	**$ 88,265**

See Notes to Financial Statements.

NOTE 1. NATURE OF OPERATIONS

UNS Gas, Inc. (UNS Gas) is a gas distribution company serving approximately 146,000 retail customers in Mohave, Yavapai, Coconino, and Navajo Counties in Northern Arizona, as well as Santa Cruz County in Southeast Arizona. UniSource Energy Services, Inc. (UES), an intermediate holding company, owns all of the common stock of UNS Gas and UNS Electric, Inc. UniSource Energy Corporation (UniSource Energy) owns all of the common stock of UES.

References to "we" and "our" are to UNS Gas.

NOTE 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

BASIS OF PRESENTATION

Our accounting policies conform to accounting principles generally accepted in the United States of America (GAAP), including the accounting principles for rate-regulated enterprises. Certain amounts reported in the prior year financial statements have been reclassified to conform to the current year presentation. These reclassifications had no effect on Net Income.

ACCOUNTING FOR RATE REGULATION

UNS Gas is regulated by the Arizona Corporation Commission (ACC) with respect to retail gas rates, the issuance of securities, and transactions with affiliated parties.

UNS Gas generally uses the same accounting policies and practices used by unregulated companies for financial reporting under GAAP. However, sometimes these principles, such as the Financial Accounting Standards Board's (FASB) Statement of Financial Accounting Standards No. 71, *Accounting for the Effects of Certain Types of Regulation* (FAS 71), require special accounting treatment for regulated companies to show the effect of regulation. For example, in setting UNS Gas' retail rates, the ACC may not allow UNS Gas to currently charge their customers to recover certain expenses, but instead may require that these expenses be charged to customers in the future. In this situation, FAS 71 requires that UNS Gas defer these items and show them as regulatory assets on the balance sheet until we are allowed to charge our customers. UNS Gas then amortizes these items as expense to the income statement as those charges are recovered from customers. Similarly, certain revenue items may be deferred as regulatory liabilities, which are also eventually amortized to the income statement as rates to customers are reduced.

The conditions a regulated company must satisfy to apply the accounting policies and practices of FAS 71 include:

- an independent regulator sets rates;
- the regulator sets the rates to recover the specific costs of delivering service; and
- the service territory lacks competitive pressures to reduce rates below the rates set by the regulator.

FAS 71 may, at some future date, be discontinued due to changes in the regulatory and competitive environments. If UNS Gas stopped applying FAS 71 to its regulated operations, it would write off the related balances of its regulatory assets as an expense and would write off its regulatory liabilities as income on its income statement. UNS Gas' cash flows would not be affected if it stopped applying FAS 71 unless a regulatory order limited its ability to recover the cost of its regulatory assets. We believe our gas operations continue to meet the criteria for FAS 71.

UTILITY PLANT

UNS Gas reports utility plant at cost. Utility plant includes material and labor costs, contractor costs, construction overhead costs, and an allowance for funds used during construction (AFUDC). We charge maintenance and repairs to operating expense as incurred.

AFUDC represents the estimated cost of debt and equity funds that finance utility plant construction. AFUDC is also allowed on certain in service gas division assets prior to their inclusion in rate base. We recover AFUDC in rates through depreciation expense over the useful life of the related asset. UNS Gas imputed the cost of capital on construction expenditures at an average of 8.12% for 2007 and 8.29% for 2006. The component of AFUDC attributable to borrowed funds is included as a reduction of Other Interest Expense on the income statement and totaled $0.3 million in 2007 and $0.1 million in 2006. The equity component is included in Interest Income and totaled $0.3 million in 2007 and $0.1 million in 2006.

We compute depreciation of utility plant on a straight-line basis over the service lives of the assets. The average annual depreciation rates for UNS Gas' utility plant were 3.28% in 2007 and 3.05% in 2006.

CASH AND CASH EQUIVALENTS

Cash and cash equivalents include cash on hand and highly liquid investments with original maturities of three months or less.

MATERIALS AND SUPPLIES

UNS Gas carries transmission and distribution materials and supplies in inventory at the lower of average cost or market.

COMPUTER SOFTWARE COSTS

UNS Gas capitalizes all costs incurred to purchase computer software and amortizes those costs over the estimated economic life of the product. We would immediately expense capitalized computer software costs if the software were determined to be no longer useful.

DEBT

We defer costs related to the issuance of debt. These costs include underwriters' commissions, discounts or premiums, and other costs such as legal, accounting and regulatory fees and printing costs. We amortize the costs over the life of the debt using the straight-line method, which approximates the effective interest method. Unamortized debt issuance costs totaled $0.8 million at December 31, 2007 and $1 million at December 31, 2006. See Note 5.

We report outstanding revolving credit balances as long-term debt when management has the intention and has the ability to roll-over outstanding balances for a period that is greater than one year.

UTILITY OPERATING REVENUES

UNS Gas records revenues from customers when the gas is delivered to our customers. Gas Revenue includes unbilled revenues which are earned (service has been provided) but not billed by the end of an accounting period. Unbilled sales are estimated for the month by reviewing the meter reading schedules and estimating the number of billed and unbilled therms for each billing cycle. Current month estimated unbilled therms are allocated by customer class. New unbilled revenue estimates are recorded and unbilled revenue estimates from the prior month are reversed.

We record an allowance for our estimate of revenues billed for which collection is doubtful. UNS Gas establishes an allowance for doubtful accounts based on historical experience and any specific customer collection issues.

Other Revenues primarily consist of miscellaneous fees, including service connection and late fees, and revenue from transportation of gas that customers purchase from other providers.

PURCHASED GAS COSTS

UNS Gas defers differences between gas purchase costs and the recovery of such costs in revenues under a Purchased Gas Adjustor (PGA) mechanism. The PGA mechanism addresses the volatility of natural gas prices and allows UNS Gas to recover its commodity costs through a price adjustor. UNS Gas may change the PGA charge monthly based on an ACC approved mechanism that compares the twelve-month rolling average gas cost to the base cost of gas, subject to limitations on how much the price per therm may change in a twelve-month period. The difference between the actual cost of UNS Gas' gas supplies and transportation contracts and that currently allowed by the ACC is deferred and recovered or repaid through the PGA mechanism. When under or over recovery trigger points are met, UNS Gas may request a PGA surcharge or surcredit with the goal of collecting or returning the amount deferred from or to customers over a twelve-month period.

RELATED PARTY TRANSACTIONS

UNS Gas receives certain corporate and administrative support services from affiliates. These costs consist primarily of employee compensation and benefits. Services from Tucson Electric Power Company (TEP) totaled $3 million in 2007 and 2006. Services from UNS Electric totaled $0.6 million in 2007 and $0.1 million in 2006. TEP, a regulated public utility serving retail electric customers in Southern Arizona, is UniSource Energy's largest operating subsidiary.

INCOME TAXES

GAAP requires us to report some of our assets and liabilities differently in our financial statements than we do for income tax purposes. We report the tax effects of differences in these items as deferred income tax assets or liabilities in our balance sheet. We measure these tax assets and liabilities using current income tax rates.

UNS Gas is a member of the UniSource Energy consolidated income tax filing. UNS Gas is allocated income taxes based on its taxable income and deductions as reported in the UniSource Energy consolidated and/or combined tax return filings. The tax liability is allocated in accordance with the income tax regulations. As a result, the regular tax liability of UNS Gas is calculated on a stand alone basis and the liability is then owed to UniSource Energy through intercompany accounts. UniSource Energy has the ultimate responsibility for payment of consolidated tax liabilities to taxing authorities and maintaining intercompany tax accounts with its subsidiaries. The Alternative Minimum Tax (AMT) liability of UNS Gas is also computed in accordance with tax regulations. This method for allocating consolidated AMT among group members considers the contribution that one member's AMT attributes provide in offsetting the consolidated AMT liability that would otherwise result if the member were not included in the consolidated group.

TAXES OTHER THAN INCOME TAXES

UNS Gas acts as a conduit or collection agent for excise tax (sales tax) as well as franchise fees and regulatory assessments. UNS Gas records liabilities payable to governmental agencies when it charges its customers for these amounts. Neither the amounts charged nor payable are reflected in the income statement.

DERIVATIVE INSTRUMENTS AND HEDGING ACTIVITIES

UNS Gas applies Statement of Financial Accounting Standards No. 133, *Accounting for Derivative Instruments and Hedging Activities*, as amended (FAS 133). Under FAS 133, all derivative instruments, except those meeting specific exceptions, are recognized in the balance sheet at their fair value.

UNS Gas purchases substantially all of its gas requirements at market prices under a natural gas supply and management agreement with BP Energy Company (BP). The contract terms allow UNS Gas to lock in fixed prices on a portion of its expected forward gas purchases from BP. This enables UNS Gas to provide more stable prices to its customers. These purchases are made up to three years in advance with the goal of locking in fixed prices on at least 45% of the expected monthly gas consumption prior to entering into the month. These forward purchases, as well as the main gas supply contract, meet the definition of normal purchases and therefore are not required to be marked to market. In February 2008, UNS Gas gave BP notice of its intention to terminate this agreement. Beginning in September 2008, UNS Gas will directly manage its gas supply and transportation contracts.

In December 2007, UNS Gas entered into a financial gas swap to assist in achieving price stabilization. This financial gas swap agreement is designated as a cash flow hedge for accounting purposes. Accordingly, unrealized gains and losses resulting from the change in fair value are recorded in Other Comprehensive Income. There were no gains or losses recognized in Net Income related to hedge ineffectiveness. Unrealized gains and losses will be reclassified into earnings when the hedged transactions settle or terminate.

The net unrealized gains and losses from UNS Gas' gas swaps reported in Other Comprehensive Income were as follows:

Cash Flow Hedges - (Gain) Loss on:	2007	2006
	-Thousands of Dollars-	
Pre-Tax Unrealized Gain on Gas Swaps	$ (82)	$ -
After-Tax Unrealized Gain on Gas Swaps	$ (49)	$ -

At December 31, 2007, the settlement date of the contract accounted for as a cash flow hedge extended through the first quarter of 2011.

UNS Gas has less than $0.1 million of Derivative Assets and less than $0.1 million of current Derivative Assets that are expected to be reclassified into earnings within the next twelve months.

FAIR VALUE OF FINANCIAL INSTRUMENTS

The carrying amounts of our current assets and liabilities approximate fair value because of the short maturity of these instruments.

UNS Gas' senior unsecured notes of $100 million outstanding at December 31, 2007 and December 31, 2006, have estimated fair values of $106 million and $102 million, respectively. UNS Gas determined the fair value of the senior unsecured notes by calculating the present value of the cash flows of each note, using a discount rate consistent with market yields generally available as of December 31, 2007 and December 31, 2006, for bonds with similar characteristics with respect to credit rating and time-to-maturity. The use of different market assumptions and/or estimation methodologies may yield different estimated fair value amounts.

EVALUATION OF ASSETS FOR IMPAIRMENT

UNS Gas evaluates its Utility Plant and other long-lived assets for impairment whenever events or circumstances occur that may indicate the carrying value of the assets may be impaired. If the fair value of the asset determined based on the undiscounted expected future cash flows from the long-lived asset is less than the carrying value of the asset, an impairment would be recorded.

ASSET RETIREMENT OBLIGATIONS

FASB Statement of Financial Accounting Standards No. 143, *Accounting for Asset Retirement Obligations* (FAS 143) requires entities to record the fair value of a liability for a legal obligation to retire an asset in the period in which the liability is incurred. FASB Interpretation No. 47, *Accounting for Conditional Asset Retirement Obligations* (FIN 47), requires entities to record the fair value of a liability regarding a legal obligation to perform asset retirement activity in which the timing and (or) method of settlement are conditional on a future event that may or may not be within the control of the entity. We record a liability when we are able to reasonably estimate the fair value of any future obligation to retire as a result of an existing or enacted law, statute, ordinance or contract. We also record a liability for the fair value of a conditional asset retirement obligation if the fair value can be reasonably estimated. When the liability is initially recorded, we capitalize a cost by increasing the carrying amount of the related long-lived asset. Over time, we adjust the liability to its present value by recognizing accretion expense as an operating expense in the income statement each period, and the capitalized cost is depreciated over the useful life of the related asset. Upon settlement of the liability, we either settle the obligation for its recorded amount or incur a gain or loss if the actual costs differ from the recorded liability amount.

NEW ACCOUNTING STANDARDS

- FAS 160, Accounting and Reporting of Noncontrolling Interests in Consolidated Financial Statements, issued December 2007, will change the accounting and reporting for minority interests, requiring such amounts to be classified as a component of equity, and will also change the accounting for transactions with minority-interest holders. The standard will be applicable for fiscal years beginning on or after December 15, 2008 on a prospective basis. Early adoption is prohibited and business combinations with acquisition dates prior to the effective date will not be adjusted upon application. We do not expect this pronouncement to have a material impact on our financial statements.

- FAS 141(R) Business Combinations - a replacement of FAS No. 141, issued December 2007, requires companies to record acquisitions at fair value. FAS 141(R) changes the definition of a business and a business combination and is generally expected to increase the number of transactions that will need to be accounted for at fair value. The standard will be applicable for fiscal years beginning on or after December 15, 2008 and generally on a prospective basis. Early adoption is prohibited and business combinations with acquisition dates prior to the effective date will not be adjusted upon application. We do not expect this pronouncement to have a material impact on our financial statements.

- FSP FASB Interpretation (FIN) 39-1, issued April 2007, allows entities that are party to a master netting arrangement to offset the receivable or payable recognized upon payment or receipt of cash collateral against fair value amounts recognized for derivative instruments that have been offset under the same master netting arrangement. Upon adoption of FSP FIN 39-1, an entity is required to make an accounting policy decision to offset or not offset fair value amounts recognized for derivative instruments under master netting arrangements. FSP FIN 39-1 became effective January 1, 2008. We will continue to present cash collateral and derivatives assets and liabilities separately in our financial statements.

- FAS 159, The Fair Value Option for Financial Assets and Financial Liabilities, issued February 2007, provides companies with the option of measuring certain financial assets and liabilities and other items at fair value with changes in fair value recognized in earnings as those changes occur. FAS 159 also establishes disclosure requirements that include displaying the fair value of those assets and liabilities for which the entity elects the fair value option on the face of the balance sheet and providing management's reasons for electing the fair value option for each item. We have not elected fair value accounting for any of our eligible financial instruments.

- FAS 157, Fair Value Measurement, issued September 2006, defines fair value, establishes a framework for measuring fair value, and expands disclosures about fair value measurements. FAS 157 clarifies that the exchange price is the price in the principal market in which the reporting entity would transact for the asset or liability. The implementation of FAS 157 on January 1, 2008 had no impact on our financial statements. We will begin disclosing inputs to develop fair value measurements and the effect of any of our assumptions on earnings or net assets for the year ending December 31, 2008.

- The Pension Protection Act of 2006 (Pension Act) became effective January 1, 2008. The new law affects the manner in which many companies, including UES administer their pension plans. The Pension Act resulted in no additional funding requirements for UNS Gas.

USE OF ACCOUNTING ESTIMATES

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

CONCENTRATION OF CREDIT RISK

As of December 31, 2007, UNS Gas had a total credit exposure related to its forward purchase contracts of less than $1 million, primarily related to its relationship with one counterparty.

NOTE 3. REGULATORY MATTERS

2007 Rate Order

In November 2007, the ACC issued a final order in the UNS Gas rate case, approving a $5 million, or 4% base rate increase. New rates went into effect in December 2007. UNS Gas had requested a $9 million, or 7% base rate increase to recover the costs related to serving its growing customer base. UNS Gas also received modifications to its PGA mechanism to help address problems posed by volatile gas prices, as discussed below.

As a result of the order allowing $0.3 million of rate case costs, UNS Gas expensed $0.6 million of deferred costs in 2007.

Energy Cost Adjustment Mechanism

UNS Gas' retail rates include a PGA mechanism intended to address the volatility of natural gas prices and allow UNS Gas to recover its actual commodity costs, including transportation, through a price adjustor. All purchased gas commodity costs, including transportation, increase the PGA bank, a balancing account. UNS Gas recovers these costs or returns amounts over-collected from/to ratepayers through a PGA mechanism. The PGA mechanism includes the following two components:

(1) The PGA factor, computed monthly, is a mechanism that compares the twelve-month rolling weighted average gas cost to the base cost of gas, and automatically adjusts monthly, subject to limitations on how much the price per therm may change in a twelve month period. Effective December 2007, the ACC Order increased the annual cap on the maximum increase in the PGA factor from $0.10 per therm to $0.15 per therm in a twelve month period.

(2) At any time UNS Gas' PGA bank balance is under-recovered, UNS Gas may request a PGA surcharge with the goal of collecting the amount deferred from customers over a period deemed appropriate by the ACC. When the PGA bank balance reaches an over-collected balance of $10 million on a billed basis, UNS Gas is required to request a PGA surcredit with the goal of returning the over-collected balance to customers over a period deemed appropriate by the ACC. Prior to December 2007 the designated under-or over-recovery trigger points were $6.2 million and $4.5 million, respectively.

The PGA surcharges in 2006 ranged between $0.05 cents per therm and $0.35 cents per therm. In 2007, the surcharge was $0.05 cents per therm through April 2007. In September 2007, the ACC approved a $0.04 cent per therm PGA credit, effective October 2007 through April 2008.

Based on current projections of gas prices, UNS Gas believes that the surcredit amount will still allow it to timely recover its gas costs. However, changes in the market price for gas, sales volumes and surcharge amount could significantly change the PGA bank balance in the future.

The following table shows the balance of over-recovered purchased gas costs:

	December 31,	
	2007	**2006**
	-Thousands of Dollars-	
(Over) Recovered Purchased Gas Costs – Regulatory Basis as Billed to Customers	**$ (3,132)**	$ (2,169)
Estimated Purchased Gas Costs Recovered through Accrued Unbilled Revenues	**(9,951)**	(8,538)
(Over) Recovered Purchased Gas Costs (PGA) Included as a Current Liability	**$ (13,083)**	$ (10,707)

2008 General Rate Case Filing

In February 2008, UNS Gas filed a general rate case (on a cost of service basis) with the ACC requesting a total increase of 7% to cover a revenue deficiency of $10 million.

In March 2008, ACC Staff indicated that UNS Gas' rate case application was insufficient since it was filed too soon after the prior case. UNS Gas is working with ACC Staff to allow the rate case to proceed.

Other Regulatory Assets and Liabilities

In addition to the Under(Over) Recovered Purchased Power Costs, UNS Gas has the following Regulatory Assets and Liabilities:

	December 31,	
	2007	**2006**
	-Thousands of Dollars-	
Other Regulatory Assets		
Pension Assets	**$ 642**	$ 1,436
Other Regulatory Assets	**852**	409
Total Other Regulatory Assets	**1,494**	1,845
Other Regulatory Liabilities		
Net Cost of Removal for Interim Retirements	**$17,318**	$ 3,999

Regulatory assets are either being collected in rates or are expected to be collected through rates in a future period, as described below:

- Pension Assets were recorded based on past regulatory actions. UNS Gas expects to recover in rates the UNS Gas portion of the underfunded pension plan for UNS Gas employees. UNS Gas does not earn a return on these costs.

- Other Regulatory assets relate primarily to rate case costs and its low income assistance program. The rate case deferrals were authorized by the ACC and are included in rate base and consequently earn a return. The recovery period is 3 years.

Regulatory liabilities represent items that UNS Gas expects to pay to customers through billing reductions in future periods or use for the purpose for which they were collected from customers, as described below:

- Net cost of Removal for Interim Retirements represents an estimate of the cost of future asset retirement obligations. These are amounts collected through revenue for the net cost of removal of interim retirements for which removal costs have not yet been expended. In December 2007, to comply with the November 2007 ACC final order, UNS Gas reclassified $12 million of Net cost of Removal for Interim Retirements from Accumulated Depreciation to Regulatory Liability.

Income Statement Impact of Applying FAS 71

If UNS Gas had not applied FAS 71, net income would have been $9 million higher in 2007 and $11 million higher in 2006 as UNS Gas would have been able to recognize over-recovered gas costs as a credit to the income statement rather than record a regulatory liability.

Future Implications of Discontinuing Application of FAS 71

UNS Gas regulatory liabilities exceeded its regulatory assets by $29 million at December 31, 2007 and $13 million at December 31, 2006. UNS Gas regularly assesses whether it can continue to apply FAS 71. If UNS Gas stopped applying FAS 71 to its regulated operations, UNS Gas would write-off the related balance of its regulatory assets as an expense and write-off its regulatory liabilities as income on its income statement. Based on the regulatory asset and liability balances, if UNS Gas had stopped applying FAS 71 to its regulated operations, UNS Gas would have recorded an extraordinary after-tax gain of $17 million at December 31, 2007. Discontinuing application of FAS 71 would not affect UNS Gas cash flows.

NOTE 4. UTILITY PLANT

The following table shows Utility Plant in Service and depreciable lives by major class at December 31:

	2007	2006	Depreciable Lives
	-Thousands of Dollars-		
Plant in Service:			
Gas Distribution Plant	$ 186,269	$ 169,110	17 – 48 years
Gas Transmission Plant	17,663	17,690	37 – 55 years
General Plant	12,445	16,354	3 – 31 years
Intangible Plant	835	997	5 – 25 years
Total Plant in Service	$ 217,212	$ 204,151	

Intangible Plant primarily represents computer software costs.

NOTE 5. DEBT

SENIOR UNSECURED NOTES

UNS Gas has $100 million of senior unsecured notes outstanding consisting of $50 million of 6.23% Notes due in 2011 and $50 million of 6.23% Notes due in 2015 that are guaranteed by UES. The senior unsecured note agreements for UNS Gas contain certain restrictive covenants, including restrictions on transactions with affiliates, mergers, liens to secure indebtedness, restricted payments, incurrence of indebtedness, and minimum net worth. Consolidated Net Worth, as defined by the senior unsecured note agreement for UNS Gas, is approximately equal to the balance sheet line item, Common Stock Equity.

The table below outlines the actual and required minimum net worth levels of UES and UNS Gas at December 31, 2007.

	Required Minimum Net Worth	Actual Net Worth
	-Thousands of Dollars-	
UES	$ 50,000	$ 168,327
UNS Gas	43,000	88,265

The incurrence of indebtedness covenant requires UNS Gas to meet certain tests before additional indebtedness may be incurred. These tests include:

- A ratio of Long-Term Debt to Total Capitalization of no greater than 65%.
- An Interest Coverage Ratio (a measure of cash flow to cover interest expense) of at least 2.50 to 1.00.

However, UNS Gas may, without meeting these tests, refinance indebtedness and incur short-term debt in an amount not to exceed $7 million. UNS Gas may not declare or make distributions or dividends (restricted payments) on its common stock unless (a) immediately after giving effect to such action no default or event of default would exist under its senior unsecured note agreement and (b) immediately after giving effect to such action, it would be permitted to incur an additional dollar of indebtedness under the debt incurrence test. As of December 31, 2007, UNS Gas was in compliance with the terms of its senior unsecured note agreement.

The senior unsecured notes may be accelerated upon the occurrence and continuance of an event of default under the senior unsecured note agreement. Events of default include failure to make payments required thereunder, certain events of bankruptcy or commencement of similar liquidation or reorganization proceedings or a change of control of UES or UNS Gas. In addition, an event of default may occur if UNS Gas, UES or UNS Electric defaults on any payments required in respect of certain indebtedness that is outstanding in an aggregate principal amount of at least $4 million or if any such indebtedness becomes due or capable of being called for payment prior to its scheduled payment date or if there is a default in the performance or compliance with the other terms of such indebtedness and, as a result of such default, such indebtedness has become, or has been declared, due and payable, prior to its scheduled payment date.

REVOLVING CREDIT AGREEMENT

The UNS Gas/UNS Electric Revolver is a $60 million revolving credit facility which matures in August 2011. Either UNS Gas or UNS Electric may borrow up to a maximum of $45 million, so long as the combined amount borrowed does not exceed $60 million. UNS Gas is only liable for UNS Gas' borrowings, and similarly, UNS Electric is only liable for UNS Electric's borrowings under the UNS Gas/UNS Electric Revolver. UES guarantees the obligations of both UNS Gas and UNS Electric.

UNS Gas and UNS Electric each have the option of paying interest at LIBOR plus 1.0% or the greater of the federal funds rate plus 0.5% or the agent bank's reference rate.

The UNS Gas/UNS Electric Revolver contains restrictions on additional indebtedness, liens, mergers and sales of assets. The UNS Gas/UNS Electric Revolver also contains a maximum leverage ratio and a minimum cash flow to interest coverage ratio for each borrower. As of December 31, 2007, UNS Gas and UNS Electric were each in compliance with the terms of the UNS Gas/UNS Electric Revolver.

As of December 31, 2007 and December 31, 2006, UNS Gas had no borrowings outstanding under the UNS Gas/UNS Electric Revolver. At December 31, 2007, UNS Gas had $10 million in outstanding letters of credit. The outstanding letters of credit, which expire on March 31, 2008, support gas purchases and are off-balance sheet obligations for UNS Gas.

NOTE 6. COMMITMENTS AND CONTINGENCIES

We record liabilities for loss contingencies, including environmental remediation costs, arising from claims, assessments, litigation, fines and penalties and other sources when it is probable that a liability has been incurred and the amount of the assessment can be reasonably estimated.

TRANSPORTATION COMMITMENTS

UNS Gas has firm transportation agreements with El Paso Natural Gas (EPNG) and Transwestern Pipeline Company (Transwestern) with combined capacity sufficient to meet its load requirements. The EPNG contract expires in August 2011, and the Transwestern contracts expire in February 2012, February 2020, and June 2023. UNS Gas made payments under the EPNG and Transwestern contracts of $13 million in 2007, and $10 million in 2006.

At December 31, 2007, UNS Gas estimates its future minimum payments under these contracts to be:

	Minimum Purchase Obligations
	-Thousands of Dollars-
2008	$ 55,927
2009	37,697
2010	25,176
2011	11,174
2012	3,174
Total 2008 – 2012	133,148
Thereafter	25,684
Total	$158,832

In January 2008, UniSource Energy was released from a $3 million guarantee of natural gas and supply payments on behalf of UNS Gas.

OPERATING LEASES

UNS Gas has entered into operating leases, primarily for office facilities and office equipment, with varying terms, provisions, and expiration dates. UNS Gas' estimated future minimum payments under non-cancelable operating leases at December 31, 2007 were:

	Operating Leases
	-Thousands of Dollars-
2008	$ 565
2009	529
2010	515
2011	531
2012	359
Total 2008-2012	2,499
Thereafter	1,539
Total	$ 4,038

UNS Gas' operating lease expense was $0.7 million in 2007 and $0.5 million in 2006.

UniSource Energy has guaranteed $2 million in building lease payments for UNS Gas.

NOTE 7. INCOME AND OTHER TAXES

INCOME TAXES

We record deferred tax liabilities for amounts that will increase income taxes on future tax returns. We record deferred tax assets for amounts that could be used to reduce income taxes on future tax returns. UNS Gas determined that a valuation allowance on the deferred income tax assets for the years 2007 and 2006 was not necessary. We reached this conclusion based on our interpretation of tax rules, tax planning strategies, scheduled reversals of temporary differences, and projected future taxable income.

UniSource Energy includes UNS Gas' taxable income in its consolidated federal income tax return. Deferred tax assets (liabilities) consist of the following:

	2007	2006
	-Thousands of Dollars-	
Gross Deferred Income Tax Liabilities		
Plant	**$ (17,368)**	$(13,984)
Other	**(379)**	(536)
Gross Deferred Income Tax Liabilities	**(17,747)**	(14,520)
Gross Deferred Income Tax Assets		
Customer Advances	**4,398**	3,894
Contributions in Aid of Construction	**2,511**	1,976
Compensation and Benefits	**522**	469
Reserve for Uncollectible Accounts	**400**	145
Other	**11**	-
Gross Deferred Income Tax Assets	**7,842**	6,484
Net Deferred Income Tax Liability	**$ (9,905)**	$ (8,036)

The net deferred income tax assets (liabilities) are included in the balance sheet in the following accounts:

	2007	2006
	-Thousands of Dollars-	
Deferred Income Taxes – Current Asset	**$ 546**	$ 284
Deferred Income Taxes – Noncurrent Liabilities	**(10,451)**	(8,320)
Net Deferred Income Tax Liability	**$ (9,905)**	$ (8,036)

Income tax expense (benefit) included in the income statement includes amounts both payable currently and deferred for payment in future periods as indicated below:

	2007	2006
	-Thousands of Dollars-	
Current Tax Expense (Benefit)		
Federal	**$ 879**	$ 3,498
State	**106**	649
Deferred Tax Expense (Benefit)		
Federal	**1,295**	(1,097)
State	**399**	(134)
Total Federal and State Income Tax Expense	**$ 2,679**	$ 2,916

The following reconciles the provision for income taxes at the federal statutory rate of 35% to the effective rate:

	2007	2006
	-Thousands of Dollars-	
Federal Income Tax Expense at Statutory Rate	**$ 2,335**	$ 2,556
State Income Tax Expense, Net of Federal Deduction	**308**	337
Other	**36**	23
Total Federal and State Income Tax Expense	**$ 2,679**	$ 2,916

UNCERTAIN TAX POSITIONS

FIN 48, Accounting for Uncertainty in Income Taxes – An Interpretation of FAS 109 (FIN 48) issued July 2006, requires us to determine whether it is "more likely than not" that we will sustain a tax position under examination. Such a position is measured to determine the amount of benefit to recognize in the financial statements. UNS Gas adopted the provisions of FIN 48 on January 1, 2007. The cumulative effect of applying this interpretation was no impact to retained earnings and the recognition of a $0.1 million uncertain tax receivable. As of December 31, 2007 the receivable has been recognized due to a settlement with the taxing authorities. During the year, no liability was recorded relating to tax positions taken in the current or prior years. It is not anticipated that unrecognized tax benefits will increase in the next 12 months. Tax years 2004 through 2006 are open under Federal and Arizona statues.

OTHER TAX MATTERS

On its 2003 and 2004 tax returns, UNS Gas elected to utilize an accounting method relating to the capitalization of indirect costs to production activities and self-constructed assets.

In August 2005, the Internal Revenue Service (IRS) issued a ruling which draws into question the ability of electric and gas utilities to use the accounting method. As a result, UNS Gas amended its 2003 and 2004 tax returns to remove the benefit previously claimed using the accounting method. In October 2006, UNS Gas remitted $0.1 million to state tax authorities. In December 2006, the IRS issued final notice disallowing the use of the accounting method. Based on the settlement guidelines relating to the accounting method that were issued by the IRS in March 2007, UNS Gas has settled this issue with the IRS. UNS Gas anticipates receiving $0.4 million of taxes and interest during 2008 which will have no impact on the overall tax provision or on net income.

OTHER TAXES

UNS Gas acts as a conduit or collection agent for excise tax (sales tax) as well as franchise fees and regulatory assessments. It records liabilities payable to governmental agencies when it bills its customers for these amounts. Neither amounts billed nor payable are reflected in the income statement.

NOTE 8. PENSION AND POSTRETIREMENT BENEFIT PLANS

UNS Gas does not maintain a separate pension plan or other postretirement benefit plan for its employees. All regular employees are eligible to participate in the pension plan maintained by our parent, UES. A small group of active employees are also eligible to participate in a postretirement medical benefit plan. UES allocates net periodic benefit cost based on service cost for participating employees.

PENSION PLAN

The noncontributory, defined benefit pension plan provides benefits based on years of service and the employee's average compensation. UNS Gas funds the plan by contributing its allocable share of at least the minimum amount required under IRS regulations.

In 2008, UNS Gas expects to contribute $0.6 million to the pension plan.

OTHER POSTRETIREMENT BENEFIT PLAN

UNS Gas assumed a $0.8 million liability for postretirement medical benefits for current retirees and a small group of active employees at the acquisition of the Arizona electric system assets. The select active employees participate in a Postretirement Benefit Plan covering employees of UniSource Energy.

INCREMENTAL EFFECT OF APPLYING FAS 158

As a result of adopting FAS 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans* (FAS 158), in December 2006, UNS Gas must recognize its allocable share of the underfunded status of the defined benefit pension and other postretirement plans as a liability. The underfunded status is measured as the difference between the fair value of the plan's assets and the projected benefit obligation for the pension plan or accumulated postretirement benefit obligation for the other postretirement benefit plan. The adjustment required to initially recognize the pension liability on adoption of this statement resulted in recognition of a regulatory asset. UNS Gas recorded its share of the required increase in the other postretirement obligation as an adjustment to Accumulated Other Comprehensive Loss as the ACC allows UNS Gas to recover other postretirement costs through rates only as benefit payments are made.

The following table presents the incremental effect of applying FAS 158, in combination with FAS 71, on individual line items in UNS Gas' balance sheet at December 31, 2006:

UNS Gas Balance Sheet Line Items:	Preliminary Balances at December 31, 2006 Before Application of FAS 158	FAS 158 Adjustment	Balances at December 31, 2006 After Application of FAS 158
		-Thousands of Dollars-	
Regulatory Assets	$ 409	$1,436	$ 1,845
Total Assets	251,457	1,436	252,893
Deferred Income Taxes - Noncurrent	8,345	(25)	8,320
Deferred Employee Benefits	939	1,499	2,438
Total Deferred Credits and Other Liabilities	23,751	1,474	25,225
Accumulated Other Comprehensive Loss (Net of Tax)	-	(38)	(38)
Total Stockholders' Equity	84,192	(38)	84,154

After the adoption of FAS 158 and before applying the provisions of FAS 71, UNS Gas had an accumulated comprehensive loss balance (net of tax) of $0.9 million attributable to its share of pension and other postretirement benefit obligations. UNS Gas subsequently recorded a regulatory pension asset of $1.4 million and an offsetting reduction on an after-tax basis of accumulated other comprehensive loss of $0.9 million, representing a reasonable approximation of UNS Gas' share of the pension plan's actuarial losses and prior service costs that are probable of recovery in rates by its regulated operations in future periods.

The pension and other postretirement benefit related amounts (excluding tax balances) included in UNS Gas' balance sheet are:

	Pension Benefits		Other Postretirement Benefits	
	Years Ended December 31,			
	2007	**2006**	**2007**	**2006**
	-Thousands of Dollars-			
Regulatory Pension Asset included in Regulatory Assets	**$ 642**	$ 1,436	**$ -**	$ -
Accrued Benefit Liability included in Accrued Employee Expenses	**-**	-	**(41)**	(51)
Accrued Benefit Liability included in Deferred Employee Benefits	**(1,283)**	(1,821)	**(422)**	(543)
Accumulated Other Comprehensive (Gain) Loss	**-**	-	**(50)**	63
Net Amount Recognized	**$ (641)**	$ (385)	**$ (513)**	$ (531)

OBLIGATIONS AND FUNDED STATUS

The actuarial present values of all pension benefit obligations and other postretirement benefit plans were measured at December 1. FAS 158 requires the measurement date to be changed to the end of the year effective December 31, 2008. The tables below reflect UES' plan information as a whole. The change in projected benefit obligation and plan assets and reconciliation of the funded status are as follows:

	Pension Benefits		Other Postretirement Benefits	
	Years Ended December 31,			
	2007	**2006**	**2007**	**2006**
	-Thousands of Dollars-			
Change in Projected Benefit Obligation				
Benefit Obligation at Beginning of Year	**$ 7,461**	$ 6,104	**$ 1,658**	$ 1,709
Actuarial (Gain) Loss	**(1,417)**	292	**(275)**	173
Interest Cost	**440**	360	**91**	94
Service Cost	**1,017**	958	**-**	-
Benefits Paid	**(149)**	(253)	**(320)**	(275)
Amendment	**-**	-	**-**	(43)
Projected Benefit Obligation at End of Year	**7,352**	7,461	**1,154**	1,658

Change in Plan Assets				
Fair Value of Plan Assets at Beginning of Year	**3,865**	2,543	**-**	-
Actual Return on Plan Assets	**173**	425	**-**	-
Benefits Paid	**(149)**	(253)	**(320)**	(315)
Contributions	**1,000**	1,150	**320**	315
Fair Value of Plan Assets at End of Year	**4,889**	3,865	**-**	-
Funded Status at End of Year	**$ (2,463)**	$(3,596)	**$ (1,154)**	$ (1,658)

At December 31, 2007, UNS Gas' proportionate share of the pension plan's funded status is approximately 52%.

The following table provides the components of UES' accumulated other comprehensive loss and regulatory assets that have not been recognized as components of periodic benefit cost as of December 31, 2007:

	Pension Benefits	Other Postretirement Benefits
	-Thousands of Dollars-	
Net Loss	**$ (976)**	**$ (62)**
Prior Service Cost (Benefit)	**2,281**	**(40)**

The accumulated benefit obligation for the UES defined benefit pension plan was $4.5 million at December 31, 2007 and $4.2 million at December 31, 2006. Changes in actuarial assumptions including an increase in the discount rate impacted the accumulated benefit obligation.

The components of net periodic benefit costs and other amounts recognized in other comprehensive income are as follows:

	Pension Benefits		Other Postretirement Benefits	
	2007	**2006**	**2007**	**2006**
	-Thousands of Dollars-			
Components of Net Periodic Cost				
Service Cost	**$1,017**	$ 958	**$ -**	$ -
Interest Cost	**440**	360	**90**	94
Expected Return on Plan Assets	**(318)**	(264)	**-**	-
Prior Service Cost Amortization	**258**	258	**(3)**	-
Recognized Actuarial (Gain) Loss	**-**	-	**4**	(12)
Net Periodic Benefits Cost	**$1,397**	$ 1,312	**$ 91**	$ 82

In 2007, UNS Gas recognized 54% of total net periodic pension benefit costs and 56% of other postretirement benefit costs based on relative employee participation.

The amounts recognized in Other Comprehensive Income (OCI) or as regulatory assets are as follows:

	Pension Benefits			
	2007		2006	
	Regulatory Asset	OCI	Regulatory Asset	OCI
	-Thousands of Dollars			
Changes in Plan Assets and Benefit Obligations Recognized in OCI or as Regulatory Assets				
Current Year Actuarial (Gain) Loss	$ (1,271)	$ -	$ -	$ -
Amortization of Actuarial Gain (Loss)	(258)	-	-	-
Prior Service (Cost) Amortization	-	-	-	-
Change in Additional Minimum Liability	-	-	-	-
Total Recognized in OCI or as Regulatory Assets	$ (1,529)	$ -	$ -	$ -

	Other Postretirement Benefits	
	2007	2006
	-Thousands of Dollars	
Changes in Benefit Obligation Recognized in OCI		
Current Year Actuarial (Gain) Loss	$ (274)	$ -
Amortization of Actuarial Gain (Loss)	(4)	-
Prior Service Cost (Credit)	-	-
Prior Service (Cost) Amortization	3	-
Total Recognized in OCI	$ (275)	$ -

UNS Gas recognized changes in benefit obligations in OCI of $0.1 million before tax. The after-tax impact in OCI of changes in benefit obligations in OCI was $0.1 million.

For the pension plan, prior service costs are amortized on a straight-line basis over the average remaining service period of employees expected to receive benefits under the plan. UES will amortize $0.3 million of prior service cost from regulatory assets into net periodic benefit cost in 2008. The estimated net loss and prior service benefit for the defined benefit postretirement plans that will be amortized from accumulated other comprehensive income into net periodic benefit cost in 2008 are less than $0.1 million, respectively.

Weighted-Average Assumptions Used to Determine Benefit Obligations as of December 1,	Pension Benefits		Other Postretirement Benefits	
	2007	2006	2007	2006
Discount Rate	6.80%	5.90%	6.50%	5.60%
Rate of Compensation Increase	3.00 – 4.00%	3.00 – 4.00%	-	-

Weighted-Average Assumptions Used to Determine Net Periodic Benefit Costs for Period Ended December 31,	Pension Benefits		Other Postretirement Benefits	
	2007	2006	2007	2006
Discount Rate	**5.90%**	5.90%	**5.60%**	5.80%
Rate of Compensation Increase	**3.00 – 4.00%**	3.00 – 4.00%	-	-
Expected Return on Plan Assets	**8.30%**	8.30%	-	-

Net periodic benefit cost is subject to various assumptions and determinations, such as the discount rate, the rate of compensation increase, and the expected return on plan assets. We estimated the expected return on plan assets based on a review of the plans' asset allocations. We also consulted with a third-party investment consultant and the plans' actuary who consider factors such as:

- market and economic indicators
- historical market returns
- correlations and volatility
- central banks' and government treasury departments' forecasts and objectives, and
- recent professional or academic research.

Changes that may arise over time with regard to these assumptions and determinations will change amounts recorded in the future as net periodic benefit cost.

	December 31,	
	2007	2006
Assumed Health Care Cost Trend Rates		
Health Care Cost Trend Rate Assumed for Next Year (Pre-65)	**8%**	9%
Health Care Cost Trend Rate Assumed for Next Year (Post-65)	**10%**	11%
Ultimate Health Care Cost Trend Rate Assumed	**5%**	5%
Year that the Rate Reaches the Ultimate Trend Rate	**2013**	2013

A one-percentage-point change in assumed health care cost trend rates would have an impact of less than $0.1 million on the December 31, 2007 amounts reported.

Pension Plan Assets

UES calculates the market-related value of plan assets using the fair value of plan assets on the measurement date. The pension plan asset allocations by asset category are as follows:

	Plan Assets December 31,	
	2007	2006
Asset Category		
Equity Securities	**66%**	64%
Debt Securities	**33%**	31%
Cash	**1%**	5%
Total	**100%**	100%

The policy for the UES pension plan is to provide exposures to equity and debt securities by investing in a balanced fund. The fund will hold no more than 75% of its total assets in stocks.

Estimated Future Benefit Payments

The following benefit payments, which reflect future service, as appropriate, are expected to be paid by UES:

	Pension Benefits	Other Postretirement Benefits
	- Thousands of Dollars -	
2008	$ 41	$ 116
2009	66	117
2010	98	117
2011	152	115
2012	237	113
Years 2013-2017	2,541	514

DEFINED CONTRIBUTION PLANS

UNS Gas offers a defined contribution savings plan to all eligible employees. The Internal Revenue Code identifies the plan as a qualified 401(k) plan. Participants direct the investment of contributions to certain funds in their account. UNS Gas matches part of a participant's contributions to the plan. UNS Gas made matching contributions of less than $0.5 million in each of 2007 and 2006.

NOTE 9. COMMON STOCK EQUITY

DIVIDEND RESTRICTIONS

The ACC limits dividends payable by UNS Gas to UES and UniSource Energy to 75% of earnings until the ratio of common equity to total capitalization reaches 40%. UNS Gas met this ratio requirement at December 31, 2007 and at December 31, 2006. Additionally, the terms of the senior unsecured note agreements contain dividend restrictions. See Note 5.

NOTE 10. SUPPLEMENTAL CASH FLOW INFORMATION

A reconciliation of net income to net cash flows from operating activities follows:

	Years Ended December 31,	
	2007	**2006**
	-Thousand of Dollars-	
Net Income	$ 3,994	$ 4,388
Adjustments to Reconcile Net Income to Net Cash Flows		
Depreciation and Amortization Expense	7,649	6,732
Depreciation Recorded to Other O&M Expense	1,112	927
Amortization of Deferred Debt-Related Costs Included in Interest Expense	192	215
Provision for Bad Debts	668	972
Deferred Income Taxes	1,694	(1,231)
Pension and Postretirement Expense	806	782
Pension and Postretirement Funding	(569)	(800)
Changes in Assets and Liabilities which Provided (Used) Cash Exclusive of Changes Shown Separately		
Accounts Receivable	2,201	(3,975)
Materials and Supplies Inventory	139	(162)
Over/Under Recovered Purchased Gas Costs	2,377	16,606
Income Tax Receivable/Payable	(355)	(242)
Accounts Payable	755	(911)
Interest Accrued	8	(21)
Taxes Accrued	(170)	329
Other	7,867	7,897
Net Cash Flows – Operating Activities	$28,368	$31,506